



Commentary

by Steve Henningsen

July 2006

When Risk Came Home to Roost!

*"If a man gives no thought about what is distant,
he will find sorrow near at hand."*

—Confucius

As May comes to a close, I am using my 11-hour journey back home from Zurich to begin writing this quarter's commentary from 33,000 feet in the air. I have spent the last eight days traveling—to San Diego, for a two-day investment conference before leaving for Zurich for the annual CFA conference. I don't choose to travel often because it is a burden on my family and a financial expense for TWC. But these occasional diversions are necessary to bring clarity and balance, as I find myself constantly battling against my very nature.

"Make your theories fit your facts, not your facts fit your theories."

—Dickerson G. Watts

I read recently how Colonel John Boyd first introduced the OODA (Observe-Orient-Decide-Act) loop concept during the Korean War, when pointing out the ability possessed by fighter pilots that allowed them to succeed in combat. Basically, before one can change and adapt, one must observe. And observe I did as this time away also allowed me to detach and ponder things.

As basic human psychology and the field of behavior finance demonstrate, humans tend to reinforce their beliefs and seek out information that validates their view (confirmation bias), even if presented with information to the contrary. It is this isolation from different views that can be dangerous, especially for those of us in the fast-moving currents of the investment markets. When one stops listening and gives up the ability to change one's mind, the game is over. Although I am an avid reader, there is a difference between information and understanding. Besides, there isn't any substitution for meeting others face to face, so when the opportunity to be among many *alternative* thinkers and observers presented itself, I eagerly signed up for the journey.

This commentary will be longer than usual (stunned silence), as it has been a busy few months with lots going on. The conference in San Diego was sponsored by investment newsletter writer, author and "big picture thinker" John Mauldin, and had a variety of speakers including the always-optimistic Art Laffer (he had an economic curve named after him); the no-nonsense Martin Barnes from the Bank Credit Analyst; and *Mr. Gold Bug*, himself, Richard Russell. The conference in Zurich offered the same intermixture of opinion and included *Mr. Doom & Gloom*, Marc Faber; *Ms. Eternal Sunshine*, Abby Joseph Cohen from Goldman Sachs; a few central banker types and countless hedge fund and bank investment managers with their own spin on things. It's not important that you know who these people are, just that they think differently and disagree on matters, which is the perfect mix for to sit back and be a fly on the wall.

I enjoyed both conferences, but won't bore you with the details. The main theme I picked up throughout both was change. I realize I've spent many a commentary writing about various changes occurring, but it is the pace of these changes that is so breathtaking. Unfortunately, humans don't adapt to change that well, at least in the short run, and historically it tends to bring about friction. These conflicts will increasingly be geo-political in nature, about issues related to natural resource scarcity. So here are what I believe to be the most important developments to keep an eye on going forward, and they shouldn't be surprising to anyone who has read my past commentaries.

Asia

Much of today's friction emanates from the development of Asia. The Asian growth story has been beaten to death lately, but it continues to amaze—the world wasn't quite prepared for the entry of two billion people into the global economy. Although economic figures released from the Chinese government are as solid as a Hollywood marriage, China's growth continues to outpace even the most optimistic projections. This has caused some economists to fear an overheating of China's economy and others (mostly U.S. congressmen) to play the "unfair advantage" card as companies continue to outsource to the East. But in a country like the U.S. that, according to GE's CEO Jeff Immelt, "*graduated more sports exercise majors than electrical engineers,*" where is this competition to come from?

One of the more interesting lectures I attended was given by CLSA Asia-Pacific Markets Chief Economist Jim Walker. His view is that China is in its late-cycle stage of the boom as rampant wage inflation, skilled-worker job-hopping and falling profitability have begun. China's big problem is that most of its workers are un-skilled and demand for higher-skilled workers is pushing up wages. (Could an inflationary trend be developing in China?) I did not realize that China currently uses one million skilled workers from Taiwan (10% of Taiwan's labor pool) and that Taiwan has no more to offer. Also, China is beginning to outsource some of its own manufacturing to places like Vietnam, where labor costs are even less. There are currently too many manufacturing plants in China (1,000 air conditioner plants alone), and Mr. Walker expects there will be a consolidation period in China, similar to when the U.S. went from 300 auto manufacturers down to three in the early 20th century. However, after its economic stumble, China will come back more competitive than ever and regain its footing to rise to its 14th century global influence in trade.

Geopolitical Risks

This concern has sat far down the list of worries of most investment professionals over the past decade, because the collapse of the Soviet Union and the U.S.'s rise to sole superpower helped alleviate worries originating from outside our borders. I believe it will take precedence again as U.S. influence begins to wane. This influence grew post-World War II when the U.S. found itself stretched out around the globe with foreign outposts throughout Europe, Japan, South Korea, the Philippines, etc. Although this network served its purpose helping to bandage together wounds inflicted during the 20th century's wars, the financial toll is beginning to take root and the U.S. is finding itself overstretched. Therefore, discussions regarding just what the U.S.'s role should be, going forward, were prevalent. It's probably not a bad thing, then, that the tide of U.S. strategic commitments is receding; military support is being reduced in Europe, Japan, and South Korea. One Asian advisor even suggested that Taiwan will soon be a part of China (the majority of the Taiwan population actually wishes it) and that South Korea will combine with North, a la Germany style.

In summary, the underlying theme of these conferences was that Asia's entry into the 21st century would bring with it many economic and political stresses, as the U.S. begrudgingly allows others back on the world's stage, while countries scour the earth to satisfy their growing need for a limited supply of natural resources.

Now, on to various observations and interesting tidbits!

"The power of accurate observation is commonly called cynicism by those who have not got it."
—George Bernard Shaw (1856-1950)

Long Live the Buck?

"I wish I had an answer to that because I'm tired of answering that question."
—Yogi Berra, baseball player and all-around guru

I have written about the dollar and inflation in the past but still receive many questions. I was about to write a long, drawn-out explanation, but thankfully, I came upon this excellent and comical summary by the folks at the website Minyanville.

Minyanville's five things you need to know to stay ahead of the pack on Wall Street:

Despite reaching levels that are technically oversold, and despite Treasury Secretary John Snow's reaffirmation Wednesday that the U.S. maintains a strong dollar policy, the greenback just can't catch a break. What's going on? What is a dollar? Why do we care whether it goes up or down in value? Isn't the dollar I'm holding today the same as it was yesterday? Why can't the Fed just print more dollars?

1. What is a dollar anyway, what does it mean?

- The dollar is simply a banknote issued by the government of the U.S. that is mandated by law to be used as legal tender for all transactions.
- Although the dollar used to be backed by gold, today it is backed simply by the promise of the government that it will be convertible in an exchange.
- Got faith? Good, you'll need it, because faith is the only thing standing between a dollar bill as exchangeable for say, a banana, and a blank sheet of paper.

2. Ok, Ok, I got faith aplenty, so where do all our dollars come from, and why can't the Fed just print more money?

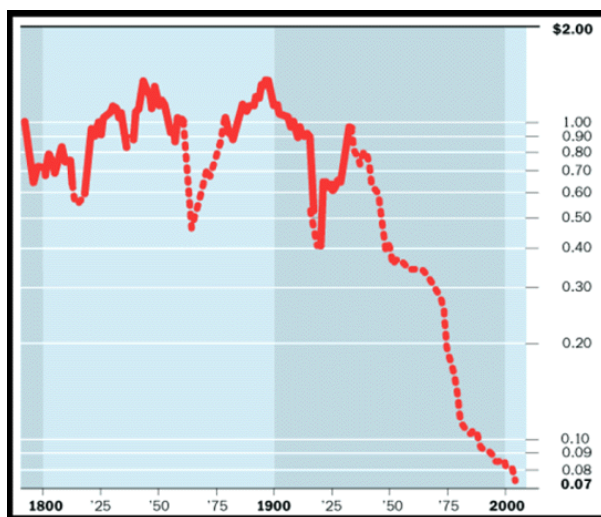
- The Fed can print money.
- And the missing M3 money supply data (which the Fed abruptly stopped publishing this Spring) suggests they do. A lot.
- But every dollar created dilutes the value of a dollar already in circulation, causing it to weaken.
- Of course, we don't notice this dilution immediately unless we travel outside the country, and if everything we consumed was produced here in America we probably wouldn't notice a weak dollar at all! Yippee!
- Wait, did you see the trade report this morning? The trade report is what we import (buy) compared to what we export (sell).
- D'oh! We ran a trade deficit of \$62 billion dollars.

3. OK, so, we're spending more than we're making, and the Fed is printing money to make up the difference. How does the Fed do it?

- The Fed "prints" money through three mechanisms. The easiest way is through the Fed's Open Market Operations. Through open market operations the Fed buys and sells, literally, Treasuries that are trading in the "open market." If the Fed buys Treasuries, then the dollars it uses to buy them become available to banks to lend. If it sells Treasuries, the dollars get taken back.
- The second mechanism is lowering the percent of deposits banks are required to have on hand - thereby increasing the pool of available money to lend.
- The third is through their "discount policy." The discount rate is the interest rate charged to commercial banks and other depository institutions on loans they receive from their regional Federal Reserve Bank's lending facility. The Fed can grow money by reducing the discount rate.

- Dollars are literally printed by the Bureau of Engraving and Printing.
4. **Trade deficit, weaker dollar... I kinda get it. The Fed has to print more money. But the more money they print, the weaker the dollar gets. Who is paying for all of this and what's the connection with foreign central banks?**
- Because we Americans as a whole spend more than we save, both individually and collectively as a government, that money has to come from somewhere.
 - Since the more money the Fed creates, the weaker the dollar gets, how do we get all these dollars to spend without collapsing the currency?
 - One way is through the purchases by central banks of countries such as China and Japan.
 - We have to "sell" our Treasury bonds to countries willing to buy our debt, paying them interest for financing our spending.
 - Foreign governments all over the world also use the dollar as a foreign exchange reserve, allowing them to control their own currency, increasing or decreasing it compared to other currencies, and to maintain stability of their currency in the event of an economic shock.
 - Because the dollar is perceived as the most stable currency in the world (note: key word is PERCEIVED) countries are willing to finance our spending by purchasing dollars and bonds.
 - But, if they begin to perceive they are not being adequately compensated for the risk of holding our debt, or if their dollars are depreciating faster than they like, these countries will demand a higher interest rate to buy our bonds. So, a weak dollar can lead to higher interest rates! That affects YOU, Mr. Homeowner-credit card spender-businessman-student!
5. **Ok, so bottom line this for me. In the simplest terms, what are the advantages or disadvantages of a stronger or weaker dollar?**
- Weak dollar - Advantages
 - Easier for U.S. companies to export goods because foreign currencies can buy "more" against the weaker dollar.
 - Tourism increases because foreign visitors find it less expensive to visit.
 - To an extent, foreigners will view investment opportunities here more favorably since they can buy more for their yuan/yen/euro/pound, etc.
 - Weak dollar - Disadvantages
 - Higher prices for consumers (We don't notice this because the Chinese yuan is tied to the dollar in a tight range and most of our imports come from China - just look at your shirt and your shoes!)
 - Higher interest rates, i.e. higher cost of money to consumers.
 - More expensive to travel abroad.
 - Strong dollar - Advantages
 - Lower prices for imported goods.
 - U.S. investors can buy foreign assets and investments at lower prices.
 - Strong dollar - Disadvantages
 - Harder for U.S. companies to compete abroad.
 - More expensive for foreigners to visit U.S.

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Figure 1: Decline in the US dollar's purchasing power (1800-2005)



Still a bit confused? Let's try a recent graph from *Barron's Magazine* to show you how your purchasing power has done over the past 200 years. Hmm...so the dollar has lost 92% of its purchasing power since the Federal Reserve was established in 1913!

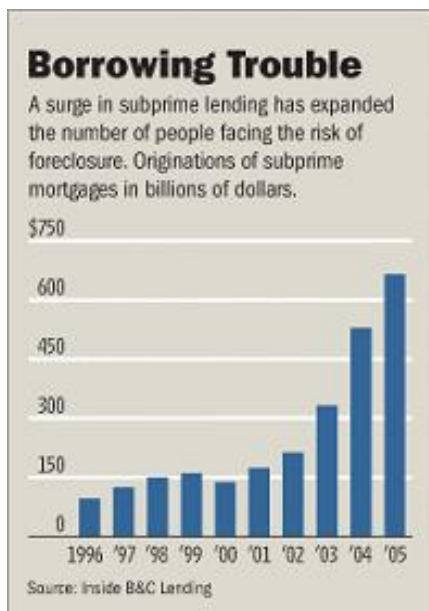
Oh, so what, Steve. At least our houses have appreciated, which makes us feel richer...right?

“If you have a house that you bought in 1970 for \$100,000 and sold it for \$400,000 today, the gain was just inflation – you made nothing. In fact, you may have lost money if you paid a 6% sales commission... Also adding insult to the inflation-injury has been the massive decline in the purchasing power of the dollar since 1970.”

—The Wall Street Journal, quoting Garrett Thornburg of Thornburg Investment Management

Actually, it is even worse, as investment manager Barry Ritholtz pointed out on his weblog: if one uses the BLS Inflation Calculator, it turns out that if you bought a home for \$100,000 in 1970, that is the equivalent of \$514,948.50 in 2006 dollars! Now, I realize that I’m beating this whole dollar/inflation thing to death, but it is an important point that many can’t seem to grasp. They figure, *If I bought a house for \$100k and sold it for \$500k 30 years later, then I made \$400k.* However, if all houses (or whatever thing you bought and sold) went up in value (inflation) then you didn’t make anything, as you can’t turn around and buy the equivalent of what you sold for less. (In the case of houses, you can, if you move from, say, Boston to Amarillo.) So, you haven’t truly “made” money on something unless it’s appreciated more than other similar assets. This is why I compare clients’ portfolio returns to the CPI Index (yes, even though it’s a tortured and manipulated measure), as you really haven’t “made” anything unless you are ahead of inflation.

Yeah, Steve--well, I still feel better in my much-appreciated house and will do just fine, thanks. Real estate is always a good investment...right?



Well, anyone feeling this way better watch out, because the real estate slowdown I’ve been expecting (admittedly, I have been “expecting” it for over a year now) appears to be here, and those looking to buy a new house may wish to wait another year. Especially if you live on the coast or in the hurricane punching-bag state, Florida. If you think foreclosures and housing supplies are high now, you ain’t seen nothing yet, as the amount of sub-prime—aka “poor risk”—loans are on the rise as shown in this graph. (By the way, Colorado leads the nation in foreclosures—we’re #1, Baby!)

Oh, and here are some additional facts; one in 55 Californians has a real estate license, interest rates have been rising, and ~ two trillion dollars in adjustable rate mortgages will see their interest-rates increase over the next 12 months for already-stretched homeowners. I don’t believe this will

end pretty and can just picture the salivating attorneys waiting to submit their class-action law suits against real estate agents, appraisers and mortgage lenders.

Yeah, Steve, but won’t the Fed save us again--remember the famous “Greenspan Put!”

Super-Fed to the Rescue – But Who Shall Be the Sacrificial Lamb?

"There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose."

—John Maynard Keynes,
The Economic Consequences of the Peace (1919)

Over the past several years, all asset prices have been going up. Houses, stocks, bonds commodities—you name it. But, as noted investor/economist Marc Faber pointed out recently in his newsletter, choices will have to be made soon as to which asset to save and which to destroy. *"If the central bank decides to support asset prices such as stocks and homes with easy money and by cutting interest rates aggressively, it is the currency that will tumble. If, on the other hand, a central bank decides to support its currency by implementing tight monetary policies and by increasing interest rates, stocks and home prices will tumble. So, whereas the Fed indeed has two options - print money and support asset prices at the cost of a weak dollar, or keep the dollar strong at the cost of weak asset markets - US assets will continue to decline in value relative to those abroad...this adjustment process will occur either through the value of the dollar or through the pricing of asset markets. Now, it should be clear that in any society, but especially in democracies, the necessary adjustments are less obvious and initially less painful to the people who vote when they occur through a weakening currency. This is particularly so in a country where most people have little interaction with foreign countries and where asset prices are, if not grossly inflated, then at least - by historical standards - elevated and highly leveraged."*

But, Steve, the economy's cranking and corporate profits are at all-time highs!

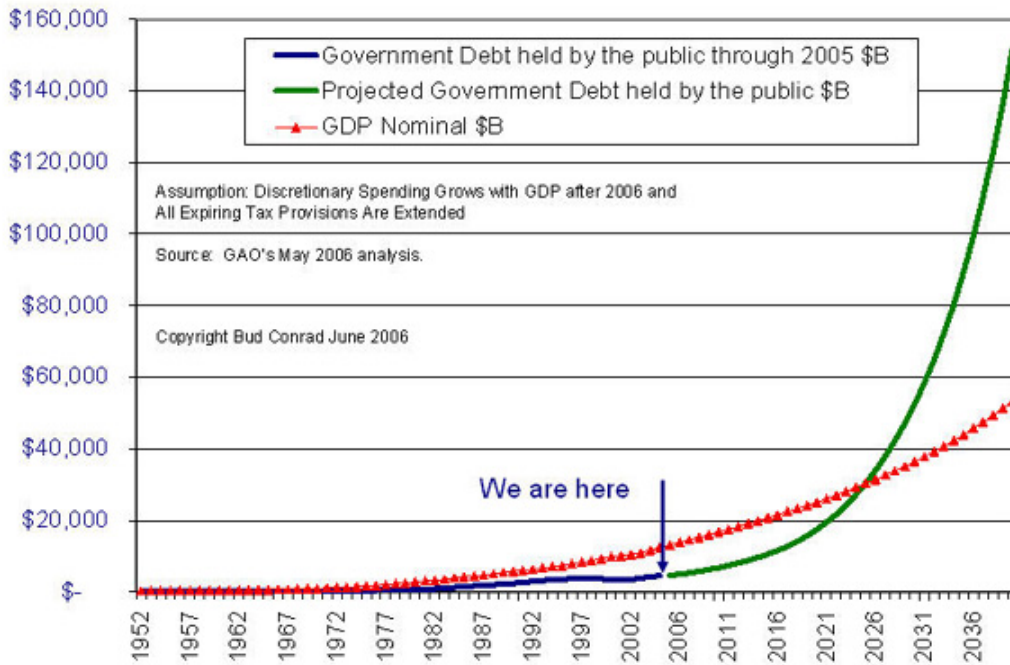
Bad Moon Arising!

"As the U.S. deficit continues to be financed easily, the optimists who think there is nothing to worry about are gaining ground over the pessimists who think an abrupt and costly adjustment is likely ...But the optimists have to be right every day while the pessimists need to be right only once."

—IMF chief economist Raghuram Rajan

Yes, corporate earnings have been stellar lately and Wall Street continues to beat the drum that the economy will grow its way out of this financial burden in the years ahead. As you know, I side with those that disagree. As the following chart, developed by investment analyst Bud Conrad, clearly shows, with current debt levels and entitlement spending, we will not be "growing" our way out of the troubles ahead.

Projected US Government Debt Will Grow More than GDP



Now, if you think this is just some crazy, conspiracy nut throwing together a chart, you should know that Mr. Conrad developed this chart with the assistance of David Walker. You might remember him from last quarter's commentary as the head of the U.S. Government Accountability Office (GAO). Anyway, Mr. Conrad used the government's numbers to put this chart together and, as he pointed out, they are conservative. For instance, he assumed that the interest rate paid by the government stays flat, even though he (and I) feels that the chance of this actually occurring is nil, given our current environment of rising interest rates.

Yeah, Steve, but as soon as those evil oil giants are slain by our fearless congressmen, oil will drop back down to the teens again and spur this economy ahead.

Fingers Pointing Everywhere but in the Mirror!

"What is even worse, by creating a false impression that evil oil companies are gouging the public, the politicians are doing nothing to help solve the real, growing crisis of the ever escalating worldwide competition for a dwindling supply for oil. While politicians hamper US oil company's ability to compete with China, they are busy using their Wal-Mart dollars to buy and securing oil supply across the world.[sic] China is drilling for oil in the Gulf of Mexico off Cuba and cutting deals with Nigeria, Iran, the Sudan and Canada. You've got Hugo Chavez in Venezuela saying he may want to sell his oil to places other than the US. You have Russia using oil as a weapon against Europe. Iran is telling us that oil is going to \$120.00 a barrel and Bolivia is nationalizing its oil industry while Nigerian rebels blow up supply. And here in America we are passing anti-gouging laws! What is wrong with this picture! The real crisis in this country is not the price of oil but the lack of imagination and leadership."

—Phil Flynn, Oil Analyst

Amen! Take a look at the gross margins of the following companies: Pfizer: 87%, Microsoft: 87%, Google: 68%, ExxonMobil: 35%, and Chevron: 24%. Given this and the fact that companies such as Citigroup and Bank of America have combined cumulative earnings greater than those of Exxon and Chevron over the past 15 years, why is it just the energy companies that

consumers are angry at and feel earn too much money? It's time we stop blaming others for our energy-wasting habits and begin searching for solutions to a problem that isn't going away.

Well, Steve, I really don't care about high energy costs, as I'm going to make a killing in the stock market since all the investment gurus are telling us how cheap stocks are!

Caveat Emptor!

"In the beginning, the promoter has the vision and the public has the money.

At the end, the promoter has the money and the public has the vision."

—Vancouver Stock Exchange parable

I have bemoaned Wall Street “experts” for several years and still can't fathom why the public continues to listen to the always-optimistic crowd. Especially, given that the securities regulators hand out fines to the brokerage firms at the same frequency as the firms hand out bonuses to themselves. (Goldman Sachs alone doled out \$11 billion in bonuses for 2005!) You would think that investors would learn their lesson, but you would be wrong. I believe investors are simply lazy, and it is easier to throw blind faith at some guru on the boob-tube than to use common sense.

Anyway, Paul Farrell recently wrote an article for the website [MarketWatch](#), entitled, *B.S. is Wall Street's Official Language*, in which he basically points out the “. . . *that Wall Street analysts scream "buy" about 95% of the time. They're born B.S.ers! Wall Street is relentlessly bullish in both the bull and bear phases of bull/bear cycles.*” Well, why not? It is in their best interest for their clients to “buy and hold” and “buy on the dips.” If they ever stated that the market was possibly overvalued, then assets would pour out of their high-management-fee funds and into slim-margin money market funds. I listed below a few of the quotes from Mr. Farrell's article, as they are from the same gurus that led their followers off a cliff a few years back and are still being followed today:

December 1999: Joseph Battipaglia, market analyst

"Some fear a burst Internet bubble, but our analysis shows that Internet companies account for only 7% of the overall Nasdaq market cap but carry expected long-term growth rates twice those of other rapidly growing segments within tech." (*The Internet Index lost two-thirds in the next six months.*)

September 2000: Jim Cramer, CNBC commentator

"SUNW probably has the best near-term outlook of any company I know." (*Within four months Sun Microsystems went from \$60 to \$30, down to \$10 in a year, below \$3 in two years.*)

January 2001: Suze Orman, financial guru

"In the low 60s here, I think the QQQ, they're a buy. They may go down, but if you dollar-cost average, where you put money every single month into them, I think, in the long run, it's the way to play the Nasdaq." (*The QQQ fell 60% further.*)

March 2001: Maria Bartiromo, CNBC anchor

"The individual out there is actually not throwing money at things that they do not understand, and is actually using the news and using the information out there to make smart decisions." (*Yes, she's serious.*)

April 2001: Abby Joseph Cohen, Goldman Sachs

"The time to be nervous was a year ago. The S&P then was overvalued, it's now undervalued." (*Unfortunately, the markets continued down for another 18 months.*)

August 2001: Lou Dobbs, CNN

"Let me make it very clear. I'm a bull, on the market, on the economy. And let me repeat, I am a bull." (*Within a year the Dow and Nasdaq lost a third more.*)

Speaking of bad advice, remember two years ago when Alan Greenspan advised homeowners to switch from their fixed-rate mortgages to adjustables?

Well, Steve, if the stock market and Federal government can't help us out of our financial mess, I guess the states will have to step in to assist us.

Everything but the Kitchen Sink!

Well, the states probably would if they weren't so busy selling their crumbling assets to fund their own obligations. There have been many articles over the past six months concerning states privatizing state assets. Here are a few:

- The State of Indiana finalized a deal to lease the Indiana Toll Road to a private consortium for \$3.85 billion up front.
- The Chicago Skyway, the Detroit-Windsor Tunnel, and the Dulles Greenway were all sold to private groups of companies in the past few years.
- New Jersey legislators have been in serious talks to lease the New Jersey Turnpike. Bankers familiar with the proposal estimate Jersey could pull in as much as \$20-\$22 billion on the deal.
- New York is seriously considering leases on several major assets, including the Tappan Zee Bridge and the New York Thruway.

In its 2005 Report Card for America's Infrastructure, the American Society of Civil Engineers (ASCE) assigned a cumulative D grade to the nation's infrastructure, saying that *"the condition of roads, bridges, drinking water systems, and other public works have shown little to no improvement since ASCE graded them a D-plus in 2001."* What do you think the odds are that these new private owners will be increasing the tolls on these roads and bridges in the near future to help pay for upkeep, and more importantly, make a profit on their investment?

Portfolio Happenings

"At first I was uncertain, but now I'm not so sure."

—Anonymous



Has someone awakened the bear? I have written about the gathering storm clouds and investors' unhealthy apathy towards risk for quite some time. Although the horizon's appearance remained ominous, the waters sat placid. That is until this quarter, when the first swell hit the global markets and left no asset class dry. And why should it, when it has spent the last several years lifting all asset classes higher? The ones that got raised the most over the past few years got soaked the most. However, gold and commodities managed to stay above water for the quarter, even after a brief setback.

Given this, clients may be pleasantly surprised to find out that their portfolios were not swamped, but actually made just shy of 1% for the quarter. Yes, nothing to click one's heels over, but positive nonetheless. Our positive performance can be attributed to a few things. First, we had sold out, or greatly reduced, our holdings last year in some of the hardest-hit asset classes—emerging markets and U.S. and international small cap stocks. Second, we had a higher than normal allocation to cash. Third, our "flexible" investment managers did a good job of preserving capital and the Prudent Bear Fund even managed to increase 5.5%, demonstrating how a manager that "shorts" stocks can add value. Fourth, our energy, commodity and gold

investments did well, gaining between 4% and 8%. Last, *but most importantly for clients to understand*, I got lucky.

Towards the end of April, I was getting a little antsy as investors were pouring money into the most volatile sections of the markets (emerging markets, commodities and gold) without even a moment's thought regarding the inherent risks. Although a frenzy in the financial markets usually makes individuals want to add to their investments, it makes me nervous, and my gut said to do something. So, I allocated a small portion (2%) of clients' money to the Profunds UltraBear Fund, to hedge against any potential market downturn. (This fund's performance corresponds to twice [200%] the inverse [opposite] of the daily performance of the S&P 500 Index.) We, therefore, were able to use the market's drop to our advantage over the next two months and captured a 12% gain before we sold it in June.

I realize that clients would rather have me say I was relying on some mathematical model to make this decision, instead of my gut. However, as I often point out, this profession is more art than science, and sometimes decisions are based upon one's perception of the psychology of the markets, as opposed to the fundamentals. Now, as to why I sold it after only two months—here my reasoning is more mathematical.

Reversion to the mean, also called regression to the mean, is the statistical phenomenon stating that the greater the deviation of a random variate from its mean, the greater the probability that the next measured variate will deviate less far. Stated another way: what goes up usually comes down. Since domestic small cap stocks have greatly outperformed their large cap siblings over the past several years, I believe they have a greater probability of underperforming them going forward. Therefore, I sold the Profunds UltraBear Fund and invested the proceeds in the Profunds UltraShort Smallcap Fund, which corresponds to twice (200%) the inverse (opposite) of the daily performance of the Russell 2000 Index. Granted, this wasn't the most tax-efficient move, but even 8% after-tax isn't too shabby. We will hold this position until I feel the risks have subsided and no longer warrant this hedge.

I'd Like to Introduce Some New Faces!

“When one can buy a U.S. Agency guaranteed FNMA [Fannie Mae] mortgage at a higher yield than almost all emerging market debt, then there exists an irrational pricing of debt.”

—Bill Gross, Pimco Bond Manager

I agree with Bill, and since I believe the economy will be slowing in the months ahead, causing corporate high yield bond defaults to rise, I began looking for a way to capture this trend. Once again, the folks at Profunds had a solution. Therefore, we invested ~2% in their Access Flex Bear High Yield Fund, which, as their prospectus states; “. . . seeks to provide inverse (opposite) exposure to the overall high yield market. That means that unlike traditional high yield mutual funds, Access Flex Bear High Yield Fund generally should increase in value when the high yield market falls—and generally should decrease in value when the high yield market rallies.” No guarantees of course, but I feel this might give us a little boost in the year ahead.

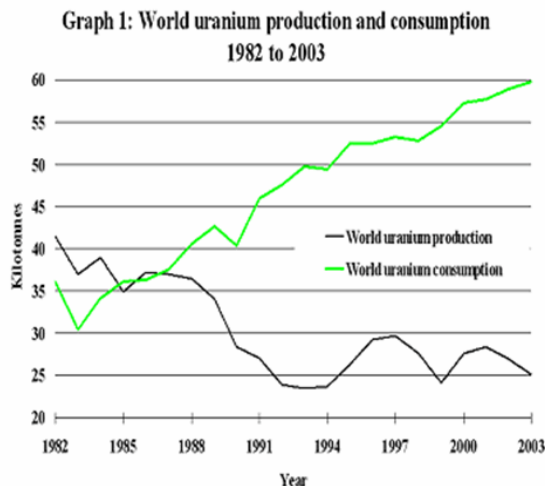
Aqua Viva!

*"Water, water, every where,
And all the boards did shrink;
Water, water, every where,
Nor any drop to drink."*

—Samuel Taylor Coleridge "The Rime of the Ancient Mariner"

The recent market sell-off gave us the opportunity to invest in a trend I first wrote about in my 4th quarter, 2004, commentary. In the section, *Water, water everywhere?*, I discussed the global fresh water problem we face in the coming decades and of my frustration that there wasn't a diversified way to invest in this trend. Well, to my giddy surprise a new ETF recently came out that focuses on this area. It's called the Powershare Water Resource Portfolio, and it is comprised of 37 stocks that ". . . focus on the provision of potable water, the treatment of water and the technology and service that are directly related to water consumption." I have allocated a small portion of clients' investments to it and plan to add to it in the near future. This will be a long-term hold. (By the way, here is another fact for you—"To produce one ton of meat takes 7 tons of corn. To produce 7 tons of corn takes 7,000 gallons of water.")

Uranium—The Other Yellow Metal!



See the underlying opportunity in this chart? I have read and written a lot about energy over the past few years. One of the growing trends is towards alternative energy sources and nuclear, in particular. Now, before you get all nervous and visions of Three-Mile Island and Chernobyl pop into your heads, give me a moment. According to the Energy Information Administration (EIA), as of 2005, 17% of the world's electricity was generated by nuclear and 37% by coal. However, due to coal's significant carbon emissions, it remains one of the largest contributors to global warming, while nuclear power plants emit practically none. (I realize that just how much coal contributes is debatable, but its effects are

not.) Even some environmentalists are touting nuclear energy over other sources. Yes, there is still the problem of what to do with the spent uranium, and it won't be a good long-term (centuries) solution, but it could get us through some tough times until another technology comes about. In addition, the technology surrounding nuclear energy has improved since the Three-Mile Island incident, as the new pebble-bed reactors show a dramatically higher level of safety and efficiency. Therefore, when one factors in the social, health and environmental benefits, nuclear is the cheapest source of electrical generation currently available.

This isn't going unnoticed either, as of 2004 the EIA showed 13 nuclear reactors being constructed and 43 proposed between China and India alone. Therefore, should the demand for nuclear power plants continue its upward trend in the future, this, obviously, will affect the price of the fuel used by the plants—uranium. Although it has risen from around \$7 per pound in 2000 to the current price of \$44, most professionals in this area expect the price to keep rising, because the nuclear power market is not uranium-price sensitive. This is because, when

compared to power plants using other sources, nuclear power plants' fuel costs are much less. Therefore, as Canadian commodity specialist, Sprott Asset Management, estimated in a recent report, “. . . *even if uranium prices rose to \$100 per pound (a further 150% increase), the cost of nuclear power would only rise by approximately 6.75%.*”

So, how do we invest in this potential trend? We could invest in some of the uranium mining companies, but some of our commodity funds already do, albeit, not that much. However, this would expose us to too much company-specific risk, and with the current trend in foreign countries not being very investor friendly (Bolivia, anyone?) it makes more sense to invest in the element itself. This wasn't easy, but I was able to locate a Canadian investment fund that “. . . *was created to invest substantially all of its assets in uranium oxide in concentrates (U_3O_8) and uranium hexafluoride (UF_6), with the primary investment objective of achieving appreciation in the value of its uranium holdings.*” The fund is called Uranium Participation Corporation and trades on the Toronto Stock Exchange. Unless some new energy source comes along soon, this will be another long-term hold for us.

As GM Goes, So Goes the Nation!

From Mr. Gross's April newsletter (emphasis is mine): *Higher inflation, higher personal and corporate taxes, and a lower dollar point U.S. and global investors away from U.S. assets and toward more competitive economies less burdened by health and pension liabilities – those personified by higher savings rates and investment as a percentage of GDP. Need I say more than to sell U.S. assets and buy Asian ones denominated in their local currencies; or if necessary to hire a global asset manager with sufficient flexibility and proper foresight to thrive in an increasingly difficult investment environment?*

Invest more in international markets and hire global “flexible” investment managers for an increasingly difficult environment—I couldn't agree more. ☺